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PAGE 01 ROME 00365 01 OF 02 091850Z

71

ACTION EUR-12

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LIMITED OFFICIAL USE SECTION 1 OF 2 ROME 0365

E.O. 11652: N/A

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SUBJECT: STATUS OF ITALIAN ECONOMY AND PROSPECTS AT END-1975

REF: A. ROME 0098; B. 75 ROME 18950; C. 75 ROME 18496

1. SUMMARY. 19775 PROVED TO BE PERHAPS WORSE YEAR FOR ITALY'S
ECONOMY IN POST-WAR PERIOD. MOST ITALIANS WERE HAPPY TO SEE
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PAGE 02 ROME 00365 01 OF 02 091850Z

IT END, EVEN THOUGH PROSPECTS FOR 1976 ARE VIEWED AS ONLY MOD-

ESTLY BETTER. DURING 1975 THERE WAS NEGATIVE GROWTH FOR FIRST TIME IN POST-WAR PERIOD. RISE IN COST OF LIVING, AGAIN, WAS EXCEPTIONALLY HIGH, AND THERE WAS GROWING UNEMPLOYMENT. HOWEVER, PROSPECTS FOR SOME POSITIVE ECONOMIC GROWTH IN 1976 ARE GOOD, PRICE INCREASED HAVE DECELERATED, RISE IN UNEMPLOYMENT HAS BEEN SURPRISINGLY MODEST, AND ITALY'S BALANCE OF PAYMENTS POSITION IS DRAMATICALLY BETTER THAN COULD HAVE BEEN EXPECTED. MAIN PROBLEM AREAS ARE UNCERTAIN PROSPECTS FOR PRODUCTIVE INVESTMENT, DANGER OF RESURGENCE OF INFLATION, AND POSSIBLE RENEWAL OF PRESSURES ON BALANCE OF PAYMENTS. UNCERTAINTIES FOR 1976 COMPOUNDED BY PRESENT GOVERNMENT CRISIS, EFFECT OF WHICH ON THE ECONOMY WILL BE TREATED IN SEPTEL.

FOLLOWING ARE KEY STATISTICAL ESTIMATES FOR 1975 AND 1976:

| 1975 | 1976 | |
|----------------------------|--------------|--------------|
| GDP (PERCENT REAL TERMS) | -3.5 TO -4.5 | 1.5 TO 3.0 |
| UNEMPLOY. AND UNDEREMPLOY. | | |
| (PERCENT OF LABOR FORCE) | 5.6 | 6.0 |
| COST OF LIVING (PERCENT) | 17 | 11.5 TO 12.5 |
| BAL. OF PAY: CURR. ACCT. | | |
| (MILLIONS \$) | 0 TO 200 | 200 TO -1200 |

END SUMMARY.

2. ECONOMIC GROWTH. MOST RECENT ESTIMATES FOR 1975 TEND TO CONFIRM THAT ITALY EXPERIENCED NEGATIVE GROWTH (GDP) FOR FIRST TIME IN POST-WAR PERIOD OF FROM MINUS 3.5 TO MINUS 4.5 PERCENT IN REAL TERMS. DROP IN FIXED INVESTMENT WAS PARTICULARLY SHARP, SOMEWHERE IN RANGE OF MINUS 11 TO MINUS 18 PERCENT. EXPORTS OF GOODS AND SERVICES (GDP CONCEPT) IN REAL TERMS WERE STAGNANT, ALTHOUGH THIS WAS RELATIVELY GOOD PERFORMANCE, GIVEN DECLINE OF 5-7 PERCENT IN VOLUME OF WORLD TRADE IN 1975. IMPORTS OF GOODS AND SERVICES FELL SHARPLY IN RANGE OF 8 TO 14 PERCENT, REFLECTING RUNDOWN IN INVENTORIES WHICH HAD BEEN ACCUMULATED IN 1973 AND 1974 AND DECLINE IN OVERALL ECONOMIC ACTIVITY. AGRICULTURAL SECTOR WAS ONE BRIGHT SPOT, WITH POSITIVE GROWTH IN RANGE OF 1.5 TO 3.5 PERCENT, WHILE MANUFACTURING SECTOR EXPERIENCED SHARP DECLINE OF PERHAPS 10 PERCENT. DECLINE IN SERVICES SECTOR WAS APPARENTLY CONSIDERABLY LESS THAN IN MANUFACTURING, IN PART REFLECTING RELATIVELY GOOD YEAR FOR TOURISM.

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PAGE 03 ROME 00365 01 OF 02 091850Z

3. FOR 1976 THERE IS GENERAL AGREEMENT THAT ITALY WILL RESUME POSITIVE GDP GROWTH PATH IN RANGE OF 1.5 TO 3.0 PERCENT IN REAL TERMS. VARIOUS STATISTICAL INDICATORS SUGGEST THAT BOTTOM OF RECESSION WAS REACHED IN THIRD QUARTER 1975, BUT RATE OF RECOVERY IS NOT EXPECTED TO ACCELERATE UNTIL SPRING OR SUMMER 1976. (THERE IS SOME POSSIBILITY THAT STATISTICAL INDICATORS IN FIRST QUARTER 1976 WILL FAIL TO CONFIRM BEGINNING OF ECONOMIC RECOVERY BECAUSE OF NORMAL SEASONAL WEAKNESS

AND BECAUSE OF LOST PRODUCTION DUE TO STRIKE ACTIVITY RELATED
TO DURING CURRENT LABOR CONTRACT NEGOTIATIONS.)

4. ONE CRITICAL ECONOMIC ISSUE NOW WIDELY BEING DISCUSSED CONCERNS BOTH SHORT-TERM AND LONG-TERM PROSPECTS FOR INVESTMENT IN FACE OF LOW PROFITABILITY OF BUSINESS AND LACK OF CONFIDENCE DUE TO POLITICAL UNCERTAINTIES. LARGE COMPANIES ALWAYS HAVE MULTI-YEAR INVESTMENT PROGRAMS UNDERWAY, AND PUBLIC SECTOR INVESTMENTS SHOULD INCREASE AS RESULT OF AUGUST 1975 ANTI-RECESSION PACKAGE. HOWEVER, KEY SMALL AND MEDIUM INDUSTRIES MAY AGAIN FAME LABOR AND CREDIT SCARCITIES AS RECOVERY GETS UNDER WAY, AND FEARS OF EVENTUAL COMMUNIST PARTICIPATION IN GOVERNMENT MAY ALSO ADVERSELY AFFECT THEIR INVESTMENT DECISIONS. ON OTHER HAND, SINCE 1975 INVESTMENT FIGURE WAS VERY LOW, 1976 FIGURE COULD AT LEAST SHOW SOME MODEST IMPROVEMENT. IN LONGER RUN, CONTINUED HIGH LABOR COSTS AND IMPACT OF PETROLEUM PRICE INCREASE CANNOT FAIL TO CREATE INCENTIVE FOR RISING INVESTMENT IN CAPITAL EQUIPMENT.

5. LARGE QUESTION MARK REMAINS CONCERNING ITALY'S LONGER TERM GROWTH PROSPECTS BECAUSE OF BALANCE OF PAYMENTS CONSTRAINT DUE LARGELY TO PERMANENT INCREASE IN PETROLEUM IMPORT BILL. WHILE SOME REDUCTION IN AVERAGE RATE OF GROWTH MAY BE POLITICALLY AND ECONOMICALLY TOLERABLE, KEY QUESTION IS AT WHAT RATE OF GROWTH BALANCE OF PAYMENTS CONSTRAINT WILL COME INTO PLAY.

6. EMPLOYMENT. MASSIVE UNEMPLOYMENT, WHICH WAS WIDELY FORECAST FROM ONSET OF RECESSION, HAS SO FAR NOT MATERIALIZED. FOUR QUARTERLY LABOR SURVEYS THROUGH OCTOBER 1975 SHOW AVERAGE UNEMPLOYMENT IN 1975 AT 3.3 PERCENT OF LABOR FORCE, COMPARED TO 2.9 PERCENT IN 1974. (FIGURE FOR 1975 WAS LOWER THAN AVERAGE UNEMPLOYMENT RATES OF 3.7 IN 1972 AND 3.5 IN 1973.) PER-LIMITED OFFICIAL USE

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PAGE 04 ROME 00365 01 OF 02 091850Z

HAPS BETTER MEASUREMENT OF SERIOUSNESS OF EMPLOYMENT SITUATION DURING 1975 WAS MEASUREMENT OF UNEMPLOYMENT PLUS UNDER-EMPLOYMENT (WITH LATTER DEFINED AS WORK WEEK OF LESS THAN 33 HOURS). AVERAGE FIGURE FOR 1975 WAS 5.6 PERCENT, COMPARED TO 4.4 PERCENT IN 1974. (1975 FIGURE ALSO EXCEEDS AVERAGE OF 5.1 PERCENT IN 1972 AND 5.0 PERCENT IN 1973.) UNLIKE PREVIOUS RECESSION OF 1970-72, LABOR FORCE HAS CONTINUED TO GROW THROUGH 1974-75. EVIDENCE TO DATE SUGGESTS THAT MECHANISM FOR INSURING AGAINST LARGE SCALE UNEMPLOYMENT AND FOR MAINTAINING INCOMES THROUGH WAGE SUPPLEMENT PAYMENTS FOR SHORT-TIME WORK HAVE BEEN QUITE EFFECTIVE IN REDUCING IMPACT OF CURRENT RECESSION. NONETHELESS, EMBASSY STILL EXPECTS SOME INCREASE OF UNEMPLOYMENT PLUS UNDEREMPLOYMENT DURING 1976, WITH AVERAGE FOR YEAR OF ABOUT 6.0 PERCENT OF LABOR FORCE.

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PAGE 01 ROME 00365 02 OF 02 092025Z

71

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LIMITED OFFICIAL USE SECTION 2 OF 2 ROME 0365

7. PUBLIC PERCEPTION OF GRAVITY OF UNEMPLOYMENT PROBLEM IS ALSO IMPORTANT IN TERMS OF CONFIDENCE FACTOR AND OF POLITICAL IMPACT. REPEATED PUBLIC STATEMENTS AND PRESS REPORTS OF SUPPOSED HIGHER LEVELS OF UNEMPLOYMENT THAN THOSE SHOWN IN OFFICIAL FIGURES HAVE CONTRIBUTED TO ERRONEOUS AND EXAGGERATED VIEWS OF UNEMPLOYMENT SITUATION. ADMITTEDLY, BROADER DEFINITION OF UNEMPLOYMENT THAN THAT USED BY STATISTICAL INSTITUTE (WHICH USES INTERNATIONALLY AGREED FORMULA IN ITS SURVEYS)

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PAGE 02 ROME 00365 02 OF 02 092025Z

WOULD RESULT IN HIGHER FIGURE FOR UNEMPLOYMENT. IN ADDITION, THERE IS CONSIDERABLE STRUCTURAL UNDEREMPLOYMENT, ESPECIALLY IN ITALY'S SOUTH. ON OTHER HAND, THERE ALSO EXISTS CONSIDERABLE HIDDEN EMPLOYMENT IN FORM OF WIDESPREAD MOONLIGHTING. IN SUM, UNEMPLOYMENT SITUATION IS NOT GOOD, AND MAY GROW SOMEWHAT WORSE, BUT ACTUAL LEVELS OF UNEMPLOYMENT HAVE BEEN FAR LOWER THAN MIGHT HAVE BEEN EXPECTED GIVEN DEPTH OF CURRENT RECESSION.

8. PRICES. ITALY'S AVERAGE COST OF LIVING ROSE ABOUT 17 PERCENT DURING 1975 COMPARED TO MORE THAN 19 PERCENT IN 1974. DECELERATION IN PRICE RISE CAN BE SEEN IN DECLINE FROM OVER 25 PERCENT TO ABOUT 11 PERCENT IN RATE OF INCREASE FROM DECEMBER TO DECEMBER FOR THESE 2 YEARS. FORECASTS OF AVERAGE INCREASE IN COST OF LIVING IN 1976 ARE AROUND 12 PERCENT. HOWEVER, THERE IS LURKING CONCERN THAT WAGE INCREASES IN 1976 WILL EXCEED GOVERNMENT TARGETS, THAT BUSINESSES WILL TAKE ADVANTAGE OF ECONOMIC RECOVERY TO INCREASE PROFIT MARGINS, THAT PUBLIC UTILITY RATES WILL BE RAISED FURTHER, AND THAT RAW MATERIAL PRICES, INCLUDING PETROLEUM, WILL AGAIN RISE SIGNIFICANTLY ON WORLD MARKETS SO AS TO JEOPARDIZE ACHIEVEMENT OF EVEN THIS MODESTLY FAVORABLE PRICE PERFORMANCE. AVERAGE MONTHLY INCREASE IN COST OF LIVING IN SEPTEMBER-NOVEMBER PERIOD OF 1.0 PERCENT, COMPARED TO AVERAGE OF 0.7 PERCENT IN PREVIOUS QUARTER, HAS SOMEWHAT STRENGTHENED THESE FEARS.

9. BALANCE OF PAYMENTS. TURNAROUND IN ITALY'S BALANCE OF PAYMENTS IN 1975 WAS DRAMATIC. UNFORTUNATELY, IN LARGE PART THIS WAS DUE TO SHARP DROP IN VOLUME OF IMPORTS DUE TO DESTOCKING AND LOW LEVEL OF BUSINESS ACTIVITY. ITALIAN EXPORTS IN REAL TERMS WERE VIRTUALLY UNCHANGED FROM 1974 LEVELS, A RELATIVELY GOOD PERFORMANCE GIVEN APPARENT OVERALL DECLINE OF 5-7 PERCENT IN VOLUME OF WORLD TRADE. ITALY'S EXPORTS TO OPEC COUNTRIES AND TO EASTERN EUROPE INCREASED SIGNIFICANTLY.

10. MANY COMMENTATORS HAVE EXPRESSED CONCERN ABOUT DANGER THAT REVIVAL OF IMPORTS IN 1976 COULD CREATE NEW BALANCE OF PAYMENTS CRISIS. WHILE THERE IS SUBSTANCE TO SUCH FEARS, SOME FAVORABLE FACTORS SHOULD BE BORNE IN MIND: (A) PATTERN OF RECOVERY SHOULD BE SLOW SO THAT THERE NEED NOT BE DRAMATIC SURGE OF IMPORTS; (B) FOREIGN CURRENCY PRICES OF ITALIAN EX-

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PAGE 03 ROME 00365 02 OF 02 092025Z

POTS GOODS SEEM STILL TO BE QUITE COMPETITIVE; (C) RECOVERY IN ITALY'S MAJOR EXPORT MARKETS (E.G., GERMANY, FRANCE, US)

WILL LIKELY PRECEDE RECOVERY IN ITALY, SO THAT DEMAND FOR EXPORTS MAY PRECEDE REVIVAL OF IMPORT DEMAND (AT LEAST FOR FINISHED GOODS); (D) ITALIAN PRODUCTIVE CAPACITY, PARTICULARLY EARLY IN 1976, SHOULD BE MORE THAN SUFFICIENT TO MEET INCREASED FOREIGN DEMAND; AND (E) ITALY WON A NUMBER OF LARGE CONSTRUCTION CONTRACTS ABROAD DURING 1975, ESPECIALLY IN OPEC COUNTRIES, SOME OF WHICH PROVIDE FOR SUBSTANTIAL ADVANCE PROGRESS PAYMENTS.

11. BALANCE IN SERVICES ACCOUNTS IN 1976 SHOULD NOT DIFFER GREATLY FROM 1975. HOWEVER, CAPITAL ACCOUNT IS LARGE QUESTION MARK, FOLLOWING UNEXPECTEDLY FAVORABLE DEVELOPMENTS IN 1975. LENGTHY POLITICAL CRISIS AND/OR NATIONAL ELECTIONS IN 1976 COULD LEAD TO RESURGENCE OF CAPITAL FLIGHT WHICH, COUPLED WITH LARGE REPAYMENTS OF FOREIGN LOANS (E.G., \$1.5 BILLION ON OUTSTANDING GERMAN GOLD LOAN), COULD CAUSE BALANCE OF PAYMENTS FINANCING PROBLEMS.

12. COMMENT. 1975 WAS BAD ECONOMIC YEAR FOR ITALY, AND FEW WILL REGRET ITS PASSING. NONETHELESS, THERE IS FAIRLY WIDE-Spread PERCEPTION THAT IT COULD HAVE BEEN WORSE, AND APPRECIATION THAT 1976 SHOULD BE AT LEAST SOMEWHAT BETTER. EMBASSY BELIEVES THAT ECONOMIC GROWTH RATE THIS YEAR COULD BE ON HIGH SIDE OF RANGE SHOWN ABOVE, BUT MAINLY BECAUSE OF VERY LOW 1975 BASE. IN FACT, MODERATION IN RATE OF 1976 RECOVERY MIGHT PROVE ECONOMICALLY ADVANTAGEOUS TO ITALY, SINCE IT WOULD MITIGATE PRESSURE ON PRICES AND ON PRECARIOUS BALANCE OF PAYMENTS SITUATION, AS WELL AS KEEPING SOME PRESSURE ON LABOR UNIONS TO MODERATE THEIR DEMANDS IN NEGOTIATIONS PRESENTLY UNDER WAY IN KEY INDUSTRIES. NEVERTHELESS, STRUCTURAL PROBLEMS, ESPECIALLY CONTINUED SHARP RISE IN LABOR COSTS WELL IN EXCESS OF PRODUCTIVITY GROWTH, HAVE CONTINUED TO UNDERMINE FUTURE ITALIAN GROWTH PROSPECTS AT TIME THAT BURDEN OF HIGHER PETROLEUM IMPORT BILL MUST STILL BE DIGESTED. VOLPE

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